No. 17039

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

A. E. MALLAGH, Trustee in Bankruptcy of the Bankrupt Estate of ORVILLE STANFORD, INC.,

Appellant,

vs.

BANK OF AMERICA NATIONAL TRUST AND SAVINGS ASSOCIATION, etc.,

Appellee.

APPELLEE'S BRIEF.

SAMUEL B. STEWART,
HUGO A. STEINMEYER,
ROBERT H. FABIAN,
650 South Spring Street,
Los Angeles 14, California,
Attorneys for Appellee Bank of America National Trust and Savings Association.

The Myers Legal Press, Los Angeles. Phone MA. 5-8820.

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Jurisdictional Statement.

Jurisdiction of the District Court was invoked under 28 U. S. C. Sec. 1334 and 11 U. S. C. Sec. 46. The jurisdiction of the United States Court of Appeals is invoked under 28 U. S. C. Secs. 1291 and 1294(1).

Procedural Statement.

The Trustee appeals from a final judgment of the District Court dismissing without leave to amend, the first claim set out in the complaint. The second claim was dismissed without prejudice by stipulation, and the judgment appealed from contains the recitals requisite to finality specified by Rule 54b, F. R. C. P. [Tr. 44-45.]

The plaintiff trustee also made a motion for summary judgment upon the first claim only [Tr. 24] which was denied by order of the District Court entered April 25, 1960. [Tr. 42.] Although plaintiff specified the denial of his motion as error, [Tr. 48] and suggests in his brief that the lower court, erred in this respect,

(Br. 13) the order of April 25, 1960 was not appealable in any event because it did not dispose of the second claim. [Tr. 42.] No question is therefore raised on this appeal as to the propriety of the District Court's refusal to grant plaintiff's motion for summary judgment. F. R. C. P. Rule 56. *Williams v. Peters,* 233 F. 2d 618 (C. A. 9, 1956); *Gillespie v. Norris,* 231 F. 2d 881 (C. A. 9, 1956).

Statement of Facts.

Appellant's statement of facts (Br. 3-4) is not controverted except in the following respects:

1. Appellant states (Br. 4) that "the transaction for this sale [of the drilling rig] was handled by the defendant Bank of America * * *." The facts are that the sale was arranged by the bankrupt, and on January 10, 1958 the purchasers and the president of the bankrupt came to the Bank in Santa Maria to close the transaction, pay the purchase price, pay off the Bank loan and get a release of the Bank's mortgage. The only "handling" of the transaction performed by the Bank was the receipt of the funds, the making of change, and the release of its lien. [Tr. 29, 35-57.]

2. We do not accept appellant's statement (Br. 4) that the Bank did not at any time record the mortgage in Kern County. The fact was that the mortgage was sent by the Bank to Kern County for recording on January 7, 1958 and returned by the Recorder to the Bank on January 14 or 15, 1958 when the Recorder was informed by the purchaser of the rig that the lien had been satisfied. [Tr. 40-41.] While it is true that the mortgage was never indexed, nor copied into the Kern County records, the mere act of lodging it with the recorder is sufficient in law to constitute a recording.

ARGUMENT.

I.

The District Court Was Correct in Its Conclusion That the Complaint in the First Claim Did Not State a Claim Upon Which Relief Could Be Granted.

a. Assuming for Purposes of Argument That the Mortgage Was Not Recorded in Kern County, Nevertheless at the Time of Payment the Bank Was an Unsecured Creditor Entitled to Be Paid and to Retain the Payment Unless by Some Provision of Federal or State Law the Payment Was Illegal.

We will assume in the first portion of the argument that the mortgage was not recorded in Kern County within thirty days of the removal of the rig to that county and that the bank, after November 8, 1958, lost the benefits of constructive notice under the provisions of Sec. 2965 of the California Civil Code.

The question therefore becomes a simple one:

Can a creditor whose security has become voidable receive and retain payment of his debt in the absence of showing of preference?

The learned District Judge answered this question affirmatively saying [Tr. 42]:

> "The mere fact that the chattel mortgage was void as to creditors does not of itself permit the trustee to recover. Assuming the chattel mortgage to be invalid, the mortgagee was nevertheless an unsecured creditor, and was entitled to payment unless the elements of a preference were present, which claim can be litigated fully under plaintiff's second cause of action."

The trustee argues (Br. 9-13) that Sections 70c and 70e of the National Bankruptcy Act (11 U. S. C. Sec. 110) provide a statutory basis for recovery. But the facts alleged do not bring him within the purview of these Sections. The trustee's power under Section 70c is limited to "property * * * upon which a creditor of the bankrupt could have obtained a lien * * * at the date of bankruptcy".

Turning to the complaint we find that the trustee alleges:

1. The bankrupt was adjudicated March 5, 1958.[1] [Tr. 3.]

2. That the mortgage covering the rig was given by the bankrupt on September 12, 1956 to secure an obligation to the Bank of $37,950. [Tr. 4.]

3. That the rig was moved to Kern County in October, 1957. [Tr. 4.]

4. That the rig was sold by the bankrupt on or about January 10, 1958 for $26,500. [Tr. 5.]

5. That $13,949.25 of the total consideration paid to the bankrupt for the sale of the rig was delivered to the defendant Bank for payment of the balance due on the obligation and in order to secure a release of the mortgage. [Tr. 5.]

6. That the mortgage was never recorded in Kern County. [Tr. 5.]

7. That there are creditors whose claims arose prior to October, 1957 who remain unpaid. [Tr. 5.]

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[1]This date is immaterially erroneous, the adjudication being February 20, 1958.

It is to be noted that the complaint contains no allegation that the Bank at any time repossessed the rig, foreclosed, or in any manner exercised any dominion over it. Two things are abundantly clear:

(a) As of February 20, 1958 the date of bankruptcy, the rig had, some 40 days earlier, passed into the possession of a bona-fide purchaser for value who had paid cash for it. No creditor on February 20, 1958 could have obtained a lien on the physical property.

(b) The money had been paid to the Bank some 40 days before the adjudication in satisfaction of the obligations then owing to it. In the absence of some agreement to hold it in trust, the money became the property of the Bank and a part of its general assets. No creditor on February 20, 1958 could have obtained a lien on the money.

We conclude that the prerequisite to the applicability of Section 70c to wit: property in existence on the date of bankruptcy as to which a creditor could have obtained a lien, has not been met, and that the complaint does not state a claim for relief under this section. Section 70c is effective only against transfers of encumbrances that are not perfected prior to the date of bankruptcy since the trustee's status as a lien creditor is fixed by the Act as of that date. (*Bailey v. Baker Ice Machine Company,* 239 U. S. 268, 276 (1915); *Martin v. Commercial National Bank,* 245 U. S. 513, 519 (1917); 4 Collier, Bankruptcy, 14th Ed., p. 1405, Sec. 70.48.)

The trustee can take no more comfort from Section 70e which gives the trustee power to avoid a transfer which "under any federal or state law applicable thereto

is fraudulent as against or voidable for any other reason by any creditor of the debtor."

It is fundamental that the trustee's rights in Section 70e are limited to those which a creditor could have enforced. In *Davis v. Willey,* 273 Fed. 397 (C. A. 9, 1921) this court said (p. 400):

> "But under Section 70e heretofore quoted the trustee may void any transfer which any creditor might have voided. This right is conferred upon the trustee to put him in a position to assert a right which the creditor might have possession in suing to set aside a transfer. The trustee is really subrogated. No new rights, no additional remedies, are created for the benefit of the creditor, other than such as the creditor would have had if it had not been for the bankruptcy."

In that case the court held that since a creditor would have been barred by the statute of limitations to set aside a fraudulent transfer, the trustee was also barred. As Professor Collier puts it "Like Prometheus bound, the trustee is chained to the rights of creditors in the bankruptcy proceeding." (4 Collier, Bankruptcy, 14th Ed., Sec. 70.90, pp. 1725-1726.)

Counsel points to no law—federal or state—which renders the transfer of the funds to the Bank either fraudulent or voidable. The mortgage lien as between the bankrupt and the Bank was extinguished by payment on January 10, 1958, and could have no existence for any purpose beyond that date. The avoidance of the mortgage lien provides no basis for recovery of either the property itself or the money paid the Bank.

In effect counsel argues that the mere fact that a mortgage once existed which could have been avoided is

sufficient ground to compel a creditor who has been paid by his debtor to repay to the estate the funds received in discharge of the debt. The law does not go this far. Indeed the limitations upon the trustee's power in this situation are found in the express grant contained in Secs. 60a and 60b of the Bankruptcy Act (11 U. S. C. A. Secs. 96a and 96b) which defines a preferential transfer and gives the trustee power to set one aside if he can prove insolvency and reasonable cause to believe insolvency. If Sections 70c and 70e mean what counsel contends there would be no necessity for Sections 60a and 60b. Presumably Congress has, by the enactment of Sections 60a and 60b, set down the requirements for the avoidance of a preferential transfer and we do not believe that it was within the legislative intent to abrogate these requirements by the adoption of Sections 70c and 70e.

The trustee cites and relies upon *Miller v. Sulmeyer,* 263 F. 2d 513 (C. A. 9, 1959), and *Chapman v. England,* 231 F. 2d 606 (C. A. 9, 1956) but does not discuss the fact situations there involved.

The *Miller* case is distinguishable on its facts from the instant situation. In that case the defendant mortgagee repossessed the mortgaged equipment in December, 1954. The bankruptcy was filed in February, 1955 while the equipment was still in the possession of the mortgagee. Thereafter in March of 1955 the mortgagee sold the equipment. This court reluctantly held that the mortgagee must pay over the proceeds of the sale of the equipment to the trustee.

It seems clear under the facts of the *Miller* case that the equipment was in existence on the date of

bankruptcy and was in the possession of the mortgagee under a voidable mortage.

It follows that in *Miller* the requirements of Section 70c of the Bankruptcy Act were met in that there was property in existence on the date of bankruptcy as to which a creditor could have obtained a lien. In the instant case as has been pointed out, there was no property in existence on the date of bankruptcy as to which a creditor could have obtained a lien.

The same distinction exists with respect to *Noyes v. Bank of Italy,* 206 Cal. 266, 274 Pac. 68 (1929), cited by the appellant at page 12. In the *Noyes* case the bankruptcy was filed August 10, 1923 at a time when the mortgaged property was still in the possession of the mortgagee under the invalid mortgage and the property was not sold by the mortgagee until August 28, 1923. There was therefore property in existence as to which a hypothetical creditor could have obtained a lien on the date of bankruptcy.

In *Chapman v. England,* 231 F. 2d 606, there was in existence at the date of bankruptcy a cause of action against the insurance company which had insured the mortgaged property against loss by fire. On the assumption that the mortgage was void for failure to comply with Section 2965 of the Civil Code as it then existed, a hypothetical creditor as of the date of bankruptcy could have garnished the proceeds of the insurance policy as of the date of bankruptcy and thereby obtained a lien. Thus the requirements of Section 70c were also met in *Chapman v. England,* but they were not met in the instant case.

It is to be noted that following the decision in *Chapman v. England* the California Legislature amended Sec-

tion 2965 of the Civil Code deleting the provision that property removed from the county of recordation for longer than 30 days was "exempted from the operation of the mortgage except as between the parties thereto." The 1957 amendment substituted as a penalty for failure to record in the county of removal a provision that "recordation shall not impart constructive notice while said property remains removed from the county * * * *Until* the mortgagee takes possession of the property as prescribed in the next section (Sec. 2966)".

By this amendment the legislature expressed an intent to override the drastic rule of *Chapman v. England* and to impair the validity of the mortgage only to the extent stated to wit: to deprive the mortgagee of the advantages of constructive notice *until* certain requirements were met. It would seem to follow from the 1957 amendment to Section 2965 that if the Bank had repossessed the equipment on January 10, 1958 the mortgage would after that date no longer be subject to attack and no creditor could have obtained a lien upon the mortgaged property as of the date of bankruptcy in February. We conclude that since the Bank would have had a right to repossess the equipment on January 10 and to sell it to satisfy the debt, it also had the right to receive and retain voluntary payment of the debt on that date.

It is to be noted that *Noyes v. Bank of Italy,* 206 Cal. 266, and *Miller v. Sulmeyer,* 263 F. 2d 513, both arose under the provisions of Section 2957 of the California Civil Code rather than under Section 2965. Where the invalidity arises under Section 2965, as amended, the taking of possession by the mortgagee prior to bank-

ruptcy removes the defect. It seems to follow that if *Noyes v. Bank of Italy* and *Miller v. Sulmeyer* had arisen under Section 2965, as amended, the results in both cases would have been different.

We do not quarrel with counsel's discussion of the rules and principals involved in *Moore v. Bay,* 284 U. S. 4, and *In re Sassard & Kimball,* 45 F. 2d 449 (C. A. 9, 1930), nor with the cases cited at page 8 of Appellant's Brief, but we do not believe that these cases help the appellant to fulfill his obligation to demonstrate that the payment of the debt to the Bank on January 10, 1958 constituted the illegal transfer of assets. In each of the cases cited on page 8 of the Appellant's Brief the trustee was seeking to invalidate a security transfer of property on some recognized ground. Our attack upon the pleading admits the invalidity of the mortgage, but we take the position that even though the mortgage may be invalid this does not prevent the mortgagee from discharging his unsecured obligation which remains unimpaired.

The same analysis applies to *Chelhar v. The Acme Garage,* 18 Cal. App. 2d 775, 61 P. 2d 1232, cited at page 12 of the Appellant's Brief. In *Chelhar* the court simply held that as between a purchaser of property at foreclosure sale and an execution creditor of the mortgagor the execution creditor prevailed where the purchaser failed to comply with the provisions of the California Vehicle Code. We fail to see the applicability of this decision here.

b. The Chattel Mortgage Was in Legal Effect Recorded in Kern County on the Date It Was Received in the County Recorder's Office on January 8, 1958.

The Affidavit of F. W. Shields discloses that on January 7, 1958 the mortgage was sent to the County Recorder of Kern County with a request that the mortgage be recorded in that county. [Tr. 40.] In the normal course of events it would be received on January 8, 1958 at Bakersfield.

Section 1170 of the California Civil Code provides that an instrument is deemed to be recorded when, being duly acknowledged or proved and certified, it is deposited in the Recorder's Office with the proper officer for record. In *Meherin v. Oaks,* 67 Cal. 57, 7 Pac. 47 (1885), Supreme Court held that a chattel mortgage is deemed to be recorded within the meaning of Section 2957 of the Civil Code when it is deposited in the Recorder's Office with the proper officer for record. It was argued that it was encumbent upon the chattel mortgagee to see to it not only that the instrument was properly executed but that it was properly indexed and placed in the record books. The court rejected this contention, stating (p. 58):

> "The mortgage, properly executed, having been deposited in the Recorder's Office with the proper officer for record, the mortgagee had done all that the law required him to do."

Other jurisdictions uniformly follow the rule that an instrument is in legal effect deemed recorded when left with the recorder. (*Chandler v. Scott,* 127 Ind. 226,

26 N. E. 297 (1891); *Jordan v. Farnsworth,* 81 Mass. (15 Gray) 517 (1896); *Bishop v. Cook,* 13 Barb. (N. Y.) 326 (1850); *Parker v. Palmer,* 13 R. I. 359 (1881); *Eastman v. Parkinson,* 133 Wisc. 375, 390, 113 N. W. 639 (1907); *Appleton Mill Co. v. Warder,* 42 Minn. 117, 43 N. W. 791 (1889); *Blair v. Richey,* 72 Vt. 311, 42 Atl. 1074 (1900).)

It is clear from these cases that a chattel mortgage is deemed recorded for the purpose of giving notice to third parties when it is delivered to, received by, and kept by the proper officer in his office for the purpose of filing, notwithstanding that he omits to place it with the other chattel mortgages in his office or that he omits to index it or to properly place it in the record book.

Since the physical act of lodging the mortgage with the Recorder constitutes an effective recording in Kern County, the provisions of Section 2965, subdivision 1 are applicable, and the mortgage from and after January 8, 1958, the date of receipt in the County Recorder's Office, imparted constructive note. The Statute says that "Recordation [in Santa Barbara County] shall not impart constructive notice while said property remains removed from the county: 1—Until the mortgagee causes the mortgage to be recorded in the county to which the property has been removed". It follows that on January 10, 1958, the date the $13,949.25 was paid to the Bank, the mortgage was perfectly valid.

Conclusion.

Whether or not the mortgage was validly recorded in Kern County at the time the payment was received by the Bank the first claim does not state facts upon which relief can be granted because there was no property in existence on the date of bankruptcy as to which a hypothetical creditor could have obtained a lien. The mortgage was validly recorded in Kern County on January 8 when it was lodged with the Kern County Recorder and the mortgage was therefore not subject to attack.

The decision of the District Court was clearly correct and should be affirmed.

Respectfully submitted,

SAMUEL B. STEWART,
HUGO A. STEINMEYER,
ROBERT H. FABIAN,
Attorneys for Appellee.